

Lecture 8 – Need for Reform (The Two Gorillas and the Future of Crises)

0) Big Idea

Since 1980, banking crises have been **ten times more frequent** and **five times more severe** than in earlier eras.

Two central drivers – the “**two gorillas in the room**”:

1. **Bank protection** (deposit insurance, bailouts, recapitalization).
2. **Mortgage/real estate subsidization** (subprime, cajas, thrifts).

These gorillas are **married**: governments often use protected banks to deliver subsidized housing credit.

→ Result: systemic risk, twin crises, and repeated fiscal collapse.

1) The Global Shift After 1980

- Median banking crisis loss: **16% of GDP** (vs. 3% in 1930s US).
 - Frequency and severity **unprecedented** in modern history.
 - Not just banks: exchange rate collapses + sovereign fiscal crises = **twin crises**.
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2) The Two Gorillas (and Sometimes a Third)

Gorilla #1 – Bank Protection

- **Deposit insurance** expansion globally (often IMF/EU driven).
- Bailouts beyond insurance (e.g., US TARP 2009, preferred & common equity injections).
- Political bargains: banks shielded from market discipline in exchange for

cooperation.

Gorilla #2 – Mortgage Subsidization

- Longstanding U.S. example: 1934 thrifts + deposit insurance enabled the **30-yr fixed-rate mortgage**.
- Reappears in:
 - U.S. Subprime (2008)
 - Spain (2008, cajas-driven housing bubble)

Gorilla #3 – Conglomerate Alliances (select countries)

- **Mexico (grupos)** and **Korea (chaebols)**: political-industrial families backed by state credit.
 - Subsidized credit + implicit guarantees fueled collapses (1994, 1997).
 - Similar dynamics in Indonesia, Thailand, Iceland.
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3) Case Studies

Mexico, 1994

- Banks re-privatized to elites with **100% liability guarantees**, no capital down.
- Exchange rate peg + fiscal expansion + sterilization → unsustainable.
- Collapse: peso maxi-devaluation, twin crisis. Fiscal bailout ≈ **25% GDP**.

Korea, 1997

- Chaebols over-leveraged, protected by banks & implicit sovereign backing.
- Issued **cheap foreign bonds** despite junk fundamentals (markets knew gov't backstop via IMF).
- Collapse cost ≈ **30% GDP**, twin crisis with sharp devaluation.
- Crisis predictable — FT/Economist forecasted months in advance.

U.S. Subprime, 2008

- Political bargains: **GSE Act (1992)** → Fannie/Freddie required to buy risky mortgages.
- Bank mergers tied to activist group deals (\$4.5T in commitments).
- By 2006: ~40% of new mortgages had ≤3% down payment; many were **no-doc**

loans.

- Market equity prices of banks showed looming insolvency long before official crisis.
- Fed's **2002–06 ultra-loose policy** lowered risk premia, fueling bubble.

Spain, 2008

- Euro entry → interest rate spreads collapsed.
 - **Cajas de Ahorros** (local political banks) expanded housing credit recklessly.
 - Real estate bust → systemic banking crisis.
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4) Twin Crises & Predictability

- **Twin crises** (banking + FX collapse) frequent in emerging markets post-1980.
 - Mechanism: fiscal costs of bank bailouts overwhelm gov't → debt monetization → currency collapse.
 - Often **forecastable** (e.g., Dornbusch on Mexico, Economist on East Asia).
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5) Global Statistical Evidence

- More generous **deposit insurance** →
 - ↑ Loans/Assets (riskier balance sheets)
 - ↓ Equity/Assets (thinner buffers)
 - ↑ Mortgage lending share (amplifies housing risk)
 - Strong evidence: deposit insurance both **raises crisis probability** and **increases severity**.
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6) Policy Lessons

- **Deposit insurance ≠ safer banks** → it incentivizes systemic risk.
 - Risk subsidies (insurance, guarantees, GSE mandates) amplify housing credit cycles.
 - Prudential regulation often **complicit** (rules opaque, capital measures phony).
 - Reform prospects are slim: political coalitions depend on these subsidies.
 - **Best hope:** transparency, market-based capital measures, less off-budget subsidization.
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7) Looking Forward

- Developed world faces **fiscal dominance**: debt levels imply future inflation/taxation crises.
 - U.S., Japan, EU, China all vulnerable.
 - Likely outcomes:
 - EMs → sovereign defaults
 - Developed economies → inflation >10% within decades (if unreformed)
 - Dollar likely to remain reserve currency – not from strength, but **lack of alternatives** (China not convertible, Euro weak, BRICS not credible).
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8) Discussion Prompts

1. Are **deposit insurance & bailouts** politically irreversible?
2. Could we design **mortgage markets** without implicit subsidies?
3. Should central banks practice **macroprudential targeting** (bubble-bursting) despite past failures?
4. How does **geopolitics** (IMF, G7, BRICS) interact with crisis vulnerability?
5. Are we destined for continued crises, or could democratic accountability shift incentives?

